

State of West Virginia
Joe Manchin III
Governor

Office of the Governor
State Capitol
1900 Kanawha Boulevard, East
Charleston, WV 25305

Telephone: (304) 558-2000
Toll Free: 1-888-438-2731
FAX: (304) 342-7025
www.wvgov.org

October 28, 2006

Dear Legislator:

I am pleased to provide you with the attached copy of the recently completed 2006 Report of the West Virginia Tax Modernization Project. As you are aware, earlier this year I asked our Department of Revenue, led by Secretary John Musgrave, to spearhead a comprehensive analysis of West Virginia's system of state and local taxation. The goal of this endeavor was to determine how our tax structure reached its current form and, most importantly, what options are available to make this system more economically competitive and fair. The team performing this analysis, officially called the West Virginia Tax Modernization Project, was comprised of executives from the Department of Revenue, including Tax Commissioner Virgil Helton, as well as leading economists from West Virginia University and Marshall University. In addition, in order to gain as much information and input as possible, the Project spent months not only researching the tax laws of West Virginia and other states, but also eliciting public comment from numerous citizens, state leaders and Legislators - all in an effort to determine how we could work together to create a more equitable and efficient tax system that encourages growth and stimulates investment to provide better paying jobs for the citizens of our State, yet also continues to fulfill our budgetary obligations.

Needless to say, the work of the Tax Modernization Project proved to be a daunting and ambitious undertaking. As the Report suggests, our current tax system has all too frequently discouraged investment, inhibited economic growth and failed to keep pace with structural changes to the economy of the 21st Century. To improve and modernize our tax laws, I believe it is clear we must streamline this system in order to create a structure that serves as an incentive for economic expansion and better paying jobs.

As with many legislative initiatives, any attempt to overhaul our tax laws will present competing considerations and some difficult choices. Indeed, I am reminded of a quip from the late Louisianan Russell Long, who, having seen his share of tax reform initiatives during his tenure as Chairman of the Finance Committee of the United States Senate, once observed, "Tax reform means 'Don't tax you, don't tax me, tax that fellow behind the tree.'" Although we can appreciate Senator Long's humor, our State's tax modernization effort should mean much more - it should mean relief to working families, it should mean stability for the public services that West Virginians deserve, it should mean increased fairness to state taxpayers, and it should also mean an improved system that encourages business development and job creation. History, however, cautions against attempting such comprehensive reform as a one-time change. As the

Legislator
October 28, 2006
Page Two

Report sets forth, many improvements to our tax structure may take years to implement fully and should therefore be phased in over time; moreover, the dynamic nature of our changing economy demands that we remain open to looking at additional measures and structures in the coming years.

That being said, some choices put before us by this Report are common-sense based and warrant our immediate attention. Therefore, as a starting point for our overall tax modernization efforts, I intend to call the Legislature into extraordinary session next month, beginning on November 9th, to implement several simple yet vitally important changes that I believe will begin West Virginia's shift toward a more modern, efficient and fair tax system. Together, we have generated a significant amount of momentum over the past twenty-two months in moving West Virginia forward. To continue this momentum, I hope you will join me in supporting the following initiatives during this initial phase of tax modernization:

* **Provide income tax relief to working families.** First and foremost, we should relieve some of the burden for working West Virginians. Although workers with incomes of \$10,000 or less are currently exempted from our state's Personal Income Tax, this threshold is simply too low and unfairly punishes West Virginians that are striving to work their way out of poverty. Accordingly, I wholeheartedly endorse the Project's recommendation to *implement an indexed family tax credit that will eliminate the Personal Income Tax on families with incomes below the federal poverty level.*

* **Expand the tax credit for property taxes paid by senior citizens.** Likewise, our treasured seniors – many of whom are on fixed or limited incomes – are frequently saddled with rising health care and transportation expenses, as well as increased property values. To help ease this load, and to protect their right to stay in their own homes for as long as possible, I propose *expanding the Senior Citizens' Tax Credit for Property Tax to provide a credit (applied against the Personal Income Tax) for the taxes paid on the first \$20,000 of assessed value over and above the homestead exemption.*

* **Give West Virginia families further reductions in their food tax.** One of the taxes that generates a significant amount of public comment and attention is the Consumers Sales and Service Tax on food and food ingredients. After months of public input on this tax, analyzing our overall tax system, and comparing West Virginia's tax structure with others, the Tax Modernization Project cautions against further reductions in the Consumers Sales and Service Tax on food – a hesitation that may largely be derived from the history of the food tax in West Virginia, and the fact that this tax has repeatedly been an on-again, off-again phenomenon in our State over the last sixty-five years.

However, with all due respect to the hard work and valid concerns of the Tax Modernization Project, I view this issue somewhat differently. Over the past two years, we have

Legislator
October 28, 2006
Page Three

asked a lot of the people of West Virginia, and they have responded by granting us the latitude to correct the sins of the past and make enormous gains toward putting our financial house in order. From the groundbreaking privatization of our workers' compensation system to the elimination of nearly \$900 million in state debt and the implementation of cost-saving measures that will save the State well over \$300 million, the people of West Virginia have placed their trust in us to do the right things. Now it is time for them to share in some of the benefits derived from the hard work of the past twenty-two months. Continuing on the responsible path that we began last year, I will propose legislation to *further reduce the Consumers Sales and Service Tax on food by another one percent this year, and an additional one percent by 2008* – effectively cutting the tax in half in two short years. This sensible approach provides nearly \$50 Million in tax relief to West Virginians and yet does so in the responsible manner that the people of West Virginia deserve and expect - and that our budget can withstand.

* **Help West Virginia businesses.** As you know, the State of West Virginia imposes two primary business taxes: the Corporation Net Income Tax and the Business Franchise Tax. Given their prominence, both of these taxes were a significant focus of the Tax Modernization Project and, as the Report suggests, both are ripe for reform. The Corporation Net Income Tax, currently set at nine percent, is among the highest in the country. *Reducing this Corporate Net rate to 8.75 percent will immediately save West Virginia businesses over \$5 Million per year.*

Similarly, and more importantly, the Business Franchise Tax rate in West Virginia is out of sync with other states, particularly given the fact that West Virginia is one of only seven states that impose both a net income tax on corporations and a franchise tax upon a businesses's net equity. Therefore, *I will propose legislation to reduce the Business Franchise Tax by over twenty percent from .70 to .55, resulting in tax savings of approximately \$25 Million per year.*

These reductions in both the Corporate Net and Business Franchise taxes – in addition to the significant premium reductions occasioned by our workers' compensation reform – will continue to ease the burden on our vitally important small businesses, while also serving as a signal to the corporate world that West Virginia truly is open for business.

* **Increase Fairness by Eliminating Inequitable Loopholes and Promoting Compliance.** As tax regulations have changed and developed in response to shifts in the economy, it frequently has been desirable to offer tax exemptions or incentives as a way to encourage investment, economic growth and business development. Unfortunately, many of these well-intended incentives have lost their effectiveness over time and yet remain on the books. As a result, we are left with a tax system riddled with exemptions and loopholes that no longer help create jobs, increase wages or expand private investment. By eliminating some of these outdated and inefficient loopholes, we can create a more equitable tax structure. Such moves also permit us to develop and enhance incentives that will target new types of businesses looking to grow and

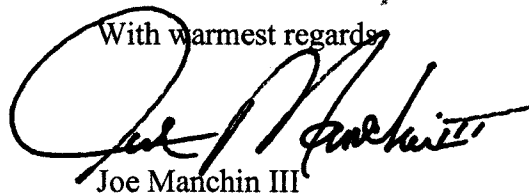
OFFICE OF THE GOVERNOR

Legislator
October 28, 2006
Page Four

invest in West Virginia and will be aimed at diversifying our economy so that West Virginia may compete on a global scale. Finally, by increasing compliance, we may ensure that everyone pays their share of taxes.

You can see additional details of my Special Session Tax Plan in the attached summary. While you will find many more topics for thought and discussion as you read through the full report of the Tax Modernization Project, I believe that the initiatives proposed for the upcoming special session are things that we can - and should - tackle quickly if we are serious about our tax modernization efforts. This first Phase of reforms includes some of the most important pieces to our overall tax modernization puzzle. Using them as a foundation, we plan to continue our work during the Regular Session in January and provide you with additional tax proposals to consider at that time once we have all had an opportunity to more fully review the Project's extremely thorough report.

I sincerely thank you for your commitment to West Virginia, and I look forward to working with you in November to provide some much-needed and well-deserved relief to our taxpayers and the businesses that employ them.

With warmest regards,

Joe Manchin III

Enclosures

Proposed Adjustment	Fiscal Impact Upon Full Implementation*	Estimated Cost of Adjustment to Existing Revenue Projections	
		FY2007 (In Millions)	FY2008
<u>Reductions</u>			
1. Reduce Sales Tax Rate on Food From 5% to 3% Rate falls from 5% to 4% on July 1, 2007** Soft Drinks, Candy & Vending Machine Sales @ 6% Rate falls from 4% to 3% on July 1, 2008	\$ (25.0)	\$ -	\$ -
2. Reduce Business Franchise Tax Rate From 0.70% to 0.55% Change effective for tax years beginning on or after January 1, 2007	\$ 3.7	\$ -	\$ 3.7
3. Increase Refundable Property Tax Credit for Seniors Increase from \$10,000 to \$20,000 effective 2007 income tax year	\$ (25.0)	\$ -	\$ -
4. Create Family Tax Credit on Income Effective July 1, 2007	\$ (25.7)	\$ (5.0)	\$ (25.7)
5. Reduce Corporate Net Income Tax Rate From 9.00% to 8.75% Change effective for tax years beginning on or after January 1, 2007	\$ (2.5)	\$ -	\$ (2.5)
6. Sales Tax Exemption for Contractors-Direct Use Manufacturing Plants Change effective as of July 1, 2007	\$ (20.0)	\$ -	\$ (10.0)
7. Increase Non-Resident Withholding Tax Rate From 4.0% to 6.5% Change effective for tax years beginning on or after January 1, 2008	\$ (5.0)	\$ (1.0)	\$ (5.0)
8. Extend Non-Resident Withholding Tax to Capital Gains on Real Estate Change effective for tax years beginning on or after January 1, 2008	\$ (3.2)	\$ -	\$ (3.2)
9. Eliminate Pre-1967 Corporate Capital Gain Exclusion Change effective for tax years beginning on or after January 1, 2008	\$ 1.0	\$ -	\$ 1.0
10. Repeal the West Virginia Capital Company Tax Credit Program*** Change effective as of July 1, 2007	\$ 0.8	\$ -	\$ 0.8
11. Tax Department RAPIDS Project Modernization Program Feedback Change assumes adequate audit, compliance, and legal staffing	\$ 3.0	\$ 1.0	\$ 3.0
12. Repeal the West Virginia Capital Company Tax Credit Program*** Change effective as of July 1, 2007	\$ 10.0	\$ -	\$ -
13. Improve Administrative Efficiency Through Modern Technology			
14. Tax Department RAPIDS Project Modernization Program Feedback Change assumes adequate audit, compliance, and legal staffing	\$ 18.0	\$ -	\$ 5.0

* Compared to current law

** Already included in existing revenue projections

*** Under current law, no credit is available until Fiscal Year 2010